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The Effect of SOX on a Corporation

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In light of scandalous events at companies such as Worldcom and Enron, President Bush signed the Sarbanes-Oxley Act on July 30,2002, in order to tighten company controls and prevent scandals from occurring in the future. The Sarbanes-Oxley Act has affected corporations in different magnitudes depending on the size of the company and the type of controls and audit system they had in place previously. In order to see the direct effect of SOX on corporations, I am going to take a closer look at the local business unit of Al's, Inc.[1], a multi-million dollar international corporation.

Al's Before SOX

Before SOX was implemented, Al's had a fairly efficient program for evaluating internal control known as ASAT (Al's Self-Assessment Test) that was established in 1997. The ASAT was completed every four to five years and had been developed in compliance with the Committee of Sponsoring Organizations (COSO), which published in 1992 a report concerning the framework of internal controls. This framework identifies five components of internal control and was considered by the SEC as an acceptable way to evaluate internal control. The five components that COSO listed were control environment, risk assessment, control activities, information and communication, and monitoring.

Taking a closer look at the COSO components, control environment is the foundation of internal control. It gives discipline and structure to the organization. Risk assessment involves management identifying and analyzing risks that are relevant to the achievement of an organization's objectives and managing the risks. Control activities are policies and procedures that ensure management carries out its directives. Information and communication is the systems support that allows the organization to

[1] The name of the company has been changed in order to protect its privacy.

obtain and distribute information in time for the organization's responsibilities to be carried out, and monitoring assesses the overall quality of internal controls.

SOX Requirements

The Sarbanes-Oxley Act has several requirements. Overall, SOX establishes the Public Company Accounting Oversight Board (PCAOB) for corporate governance, disclosure, and auditor standards. Specifically, Section 404 of SOX directs the SEC to require each annual report of a company to have two components related to internal controls. The first component is a statement of management's responsibility for establishing and maintaining adequate internal controls and procedures concerning financial reporting. The second component is management's assessment of the effectiveness of the company's internal controls and procedures for financial reporting during the most recent fiscal year.

Changes in ASAT due to SOX

The basic changes in 2004 to the ASAT because of SOX were greater accountability, better technology, more frequent testing, better documentation, and constant improvement. SOX requires greater accountability because of the statement of management's responsibility and management's assessment of internal controls. Al's established more accountability by appointing an ASAT coordinator at each business unit location. The ASAT coordinator coordinates testing activity and responsibility, ensures that testing is performed to the required standard, and ensures that all key controls have been tested. Although the coordinator is in charge of making certain that the overall requirements are met on each individual level, management has established standards for keeping adequate internal controls. A separate process has been developed to evaluate the internal control awareness of executive management. In order for management to stay on

track with accountability requirements, the ASAT program has a new set-up. For example, full time resources such as money, interns, and technology programs are now dedicated to SOX compliance activities and keeping management informed of the ASAT progress and identified audit issues. When I worked at Al's we would have weekly three-hour meetings with all employees involved in ASAT to keep people informed. At the meetings, each person reported the testing that had been done that week, and anyone could ask questions of other ASAT workers. Also, at the end of each meeting a timetable was updated to see where the company was as a whole.

The second change in ASAT because of SOX is better technology to make the audit process more efficient. Each year, Al's reviews the SOX objectives and updates technology. During the first year, Al's used Trend Tracker for documentation. During 2005, the system was updated and is now known as STARS Compliance. STARS has the same basic components that Trend Tracker had: a place to enter minimum requirements, objects, and testing results. However, STARS provides improved system performance with a new user interface, allows carry-forward documentation and multiple testing cycles, and enhances reporting capabilities. In addition to these technological improvements, STARS is used throughout Al's worldwide, which standardizes Al's audit process. Therefore, the ASAT can be reviewed by Al's employees from all Finance Departments across the world. My experience with STARS was that although it provided improvements, the change in the user interface was more problematic than helpful for the employees that were familiar with using Trend Tracker. Overtime, the benefits of the new technology will most likely outweigh the hassle of the new system, but in the short run, the new system was not efficient.

In addition to the new audit software provided by STARS, Al's improved technology with new Enterprise Business System (EBS) software. One of the major changes in this EBS software is stronger control on segregation of duties. For example, a person using the Oracle Requisition to Payment software cannot create a purchase order as well as perform the receiving function. Also, computer systems in the areas of security and change control are scrutinized more closely. As a result, access to any system related to the financial system (purchasing, maintenance, inventory control, invoicing) is restricted to people authorized by management. The scrutiny involves physical security of information systems and log on access. In addition, there is much tighter review by Al's Industrial Technology Coordinator on software application and changes to existing programs.

The third change in ASAT due to SOX is more frequent testing. SOX requires the ASAT to be performed annually instead of once every four to five years. In 2006, employees will be required to complete the ASAT/SOX audit throughout the entire year rather than in the few months before PricewaterhouseCoopers comes to audit. This continuous audit will take place because the internal control review has become a systemized management process. In addition to the continuous audit, a greater urgency exists to remediate findings with internal control issues in a shorter time frame. As part of the ongoing audit, SOX requires that some objectives be tested more than once per year. The number of times a test must be performed depends on how often the control is performed. See Figure 1 below to determine how many times a test must be performed.

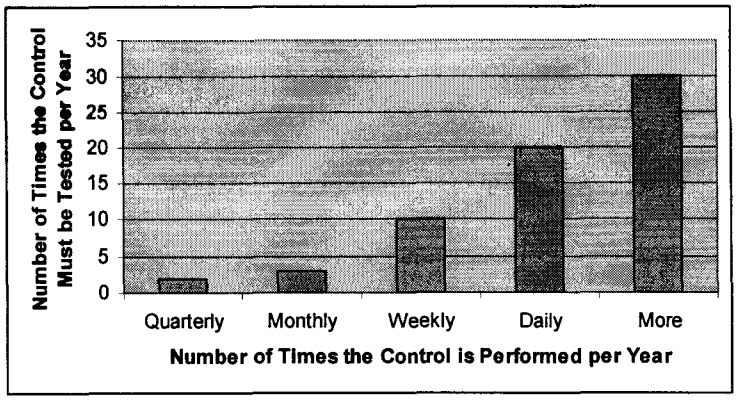

Figure 1. Number of Testing Times per Year.

The fourth change in ASAT due to SOX is better documentation. One major change in documentation is that all major financial processes must be documented as written procedures or flowcharts. This enables auditors to gain an understanding of a location's internal control system prior to the audit. Documentation of procedures also helps in training employees and reduces the likelihood that material errors will occur in the financial statement. From my experience at Al's, documenting all processes took a long time because they were not previously documented. See Figures 2 and 3 below for flowchart examples.

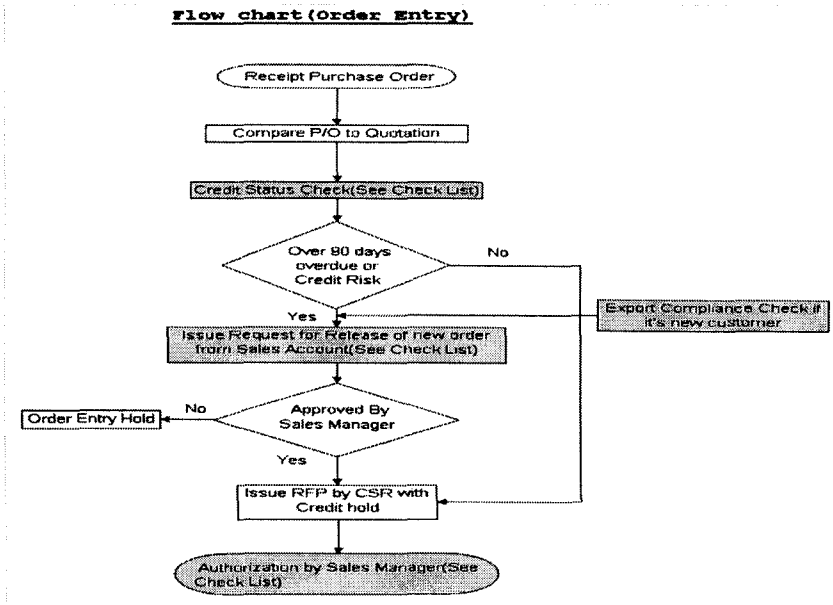

Figure 2. Flowchart example for order entry.

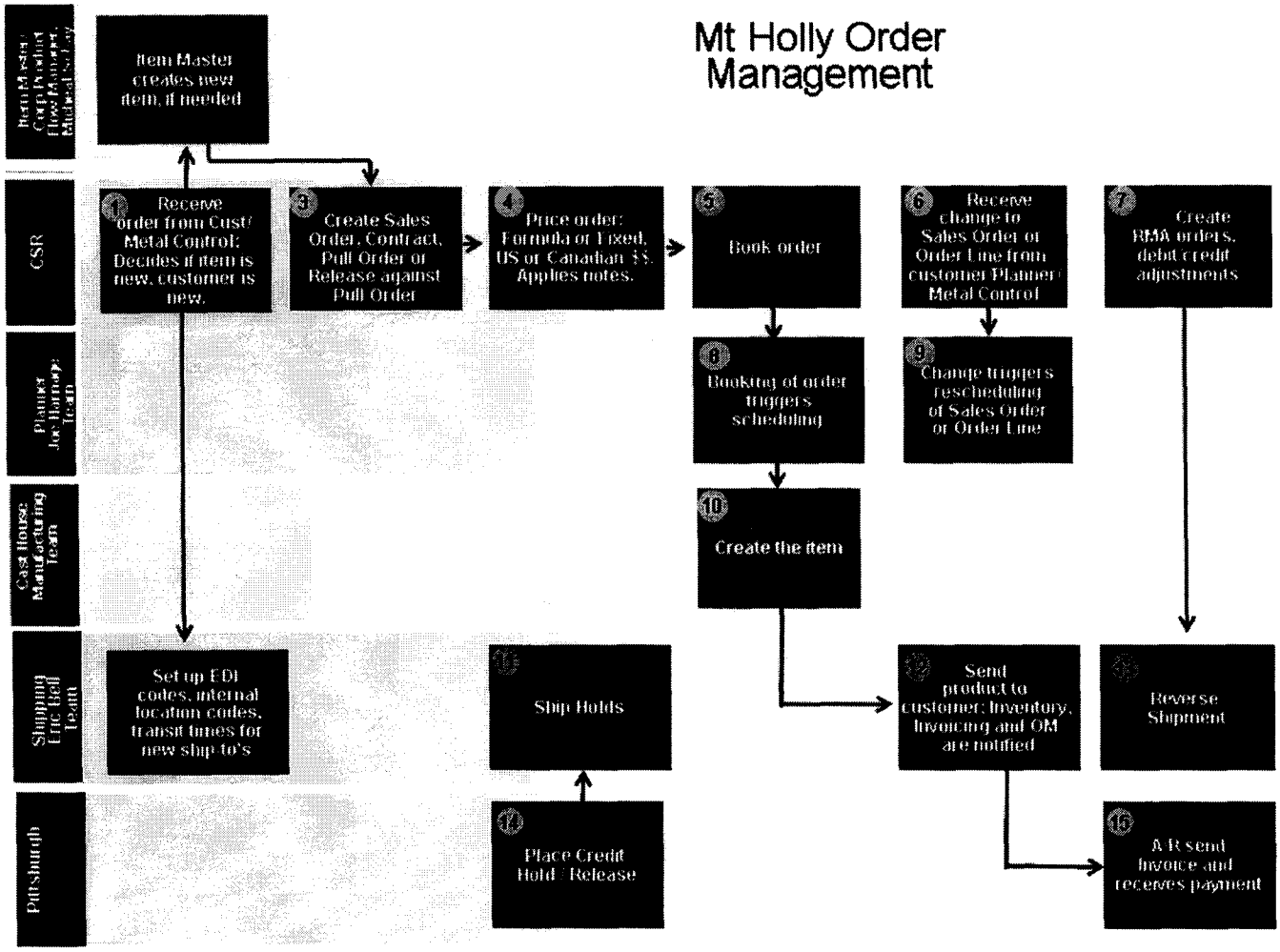

Figure 3. Flowchart example for order management.

In addition to better process documentation, a much greater emphasis exists on standards involving gathering audit evidence. Sufficient documentation is one of these standards that is concerned with gathering evidence. Sufficient documentation should include a clear explanation of the control and the control should actually be tested. Often people will document a control and then forget to perform the testing. Figure 4 below shows how controls were previously documented and the proper way to document controls. The documentation on the right side gives a clearer explanation of what process is being done, how the process is being performed, and why the process is completed.

Original	Suggested
Every month the manager performs a review of the exception report which highlights any overdue amounts.	**Objective:** To test that the monthly review of exception reports is taking place. **Background:** Every month the manager performs a review of the exception report which highlights any overdue amounts. **Testing performed:** Selected judgmentally a sample of 3 reports and confirmed that these were signed as reviewed by the manager. The sample size was chosen to comply with Alcoa's minimum sample size requirement guidelines.....etc etc...

Figure 4. Proper Control Testing Documentation

After explaining what control is being tested and testing it, the next important step in better documentation is a clarification as to how the sample size was selected. For completeness, SOX compliance recommends to describe why a certain sample size was chosen and to describe the method that was chosen for selecting the sample. Figure 5 below shows proper documentation of sample size selection.

Current (good)	Suggested
Obtained a listing of requisitions and performed testing using "sampling by intervals" method, and tested 10% of the data. Attached is the data that was tested....	Obtained a listing of requisitions. A sample was selected using a "sampling by intervals" method, resulting in a 10% sample of the population. The sample size of 10% is consistent with the Alcoa suggested sample sizes.....

Figure 5. Proper Sample Size Selection Documentation.

After the sample is tested, including a conclusion that states how the test's minimum expectation was met is required. This involves preparing a paragraph that states the implication of the testing results. Normally, this conclusion will state that the minimum expectation was met and that the control works properly. When a control does